

Ms. Anderson,

As a practicing CPA, I am writing as an interest person on ESHB 2023 (the "Washington Jobs Act") to submit my comments on rules for crowd funding.

This bill has the potential to be ground-breaking in the provision of access to capital for small businesses. Successful execution of this proposal can lead to this being an example by which small business capitalization can be revolutionized nationwide. However there are distinct risks to both the issuers and potential investors that must be adeptly addressed to ensure successful execution of this act. Unfortunately, as I will discuss, these risks are conflicting in nature, and thus an effective compromise must be reached in order to effectively mitigate the risks posed to both issuers and investors and allow for a successful crowd-funding mechanism.

From my experience, I consider the primary risk posed to potential investors to be that they have inadequate information to make an informed investment on. This is a risk in any investment, but I consider it to be amplified by the fact that the investments subject to this act will be highly speculative in nature, and made by investors, who in all likelihood are not sophisticated investors and will lack extensive investing experience. Another significant risk faced by any potential investor is that of fraudulent ventures, as access to capital as set forth in this act that is subject to limited scrutiny and regulation will surely attract more than a few wolves.

Conflictingly, the primary risk for potential issuers is the loss of secrecy, as it is beneficial for growing companies to maintain a veil of secrecy around the exact nature, extent, and scale of their operations to avoid disclosing potential competitive advantages to competitors. Additionally, the aim of this bill is to provide easy access to capital, imposing too strict of reporting and disclosure requirements may act as a deterrent as well.

The question then becomes how do you develop a set of rules which protects investors and allows them access to sufficient information to make an informed investment decision without deterring companies by requiring excessive disclosures.

Comments on Potential Solutions:

The first recommendation I have is that each issue should be accompanied by some form of prospectus (and quarterly updates shall be provided to investors) which shall include certain required disclosures which I believe should include:

1. Financial Statements – Balance Sheet, Income Statement, Cash Flows
  - a. While the accounting systems of an issuer do not need to be complex, adequate reporting capabilities should be present in order for investors to monitor the financial condition of these companies. I believe that these financial statements should be made available to investors on a quarterly basis, however, I do not agree with the current language of the bill which states that quarterly updates be posted publicly on a company's website. In order to protect (to some extent) the privacy of these issuers, I believe that these updates should be made only to investors in confidential form. Given the volume of potential investors in any given issue, it may be argued that this is not much protection of privacy as all a competitor would need do is to have an employee buy a share in the offering to become privy to this information.

I believe however, that in weighing the interests of the issuer and the investor, the concerns of the investor must always be of primary concern given the issue of adverse selection as there is asymmetric information present. Thus, given the low price of this type of capital financing, I believe that for companies truly seeking to access this form of funding, information is a price which must be paid. Further, financial statements are essential for investors to derive a valuation for an issuing company. Without adequate financial information, the investor has no basis on which to determine whether or not an issue is at a reasonably fair price. Even a great company can certainly be a bad investment at the wrong price, and without disclosure of financial information, we are no longer discussing investments but are entirely in the realm of speculation.

2. Certain Metrics – Cash Burn Rate, Revenue Driver Growth Rate
  - a. I also believe that certain financial metrics are essential to evaluation of these highly speculative investments. One is the cash burn rate for previous periods, and expected burn rate moving forward. This is an essential metric used by VC firms to evaluate the solvency of a portfolio company. It allows investors to get an estimate of the current immediate financial health of a potential investment company. Another potential disclosure may include identification of the primary revenue driver (i.e. number of customers or relationships) and the historical growth, as well as expected growth of this driver. This can help investors get a better idea of the business potential of a Company.
3. This prospectus should also include a summary of the status of the business. Specifically, I believe it should include an assessment of the current status of the company's primary offering. For example, if a company is developing a new software, it should disclose the current status of the software, and the timeline for development, including the expected timing of when it would become marketable.
4. Specific and significant risk factors should also be addressed so that investors are fully aware of all potential risks faced by an investment. This is an essential part of the evaluation stage made by venture capital firms, as they would never invest in a company without a full understanding of the risks present in the investment. This is a right I believe potential crowd-funding investors should have as well.
5. Use of funds as well as changes in use of funds. Also essential to the success of this initiative I believe is the disclosure of the use of the funds. It is important for an investor to understand why a company is undertaking a financing and what it intends to do with the funds raised. Are the funds to be used to pay executives? Continue product development? Increase market visibility? Meet operating expenses? This is an integral part of any loan or public securities sale, and thus, it is extremely informative in this context as well. Any change or deviation from the initial disclosed purpose I believe should be disclosed to investors immediately.
6. Finally, I believe these prospectuses, and quarterly updates, should be subject to certain review or otherwise standard and established procedures from an independent accounting firm. The cost of such procedures would not exceed a set price (likely somewhere in the \$10k-\$50k range) which considered in connection with the ability to raise up to \$1M, is not an unreasonable price to pay for the additional protection of investors, and still makes this a very affordable and accessible form of financing. The review procedures would largely include analytical procedures

and inquiries with personnel, as well as certain fraud procedures (background checks, inquiries, review of cash accounts).

My next recommendation is that all issuers should have an established corporate governance system, with a board of directors. To protect the future interest of those investors participating in the crowd-funding, the securities sold in the issue, as a class, should be allotted a seat on the board of directors, to be appointed by a proxy vote of the holders. This is another standard protocol of any VC investment as it allows the investor to stay informed and monitor the direction of the business. I believe this to be an essential aspect of a successful crowd-funding infrastructure.

My final recommendation is in the requirements for the investment security itself. Typical venture financings are in the form of convertible preferred shares, or mezzanine, securities. In the event of a liquidation, this protects the interest of these shareholders, as well as allows them to access to the upside potential of the business. Among the requirements of the security I believe that shares sold in a crowd-fundraising should:

1. Be convertible preferred shares with:
  - a. A liquidation preference equal to the issuance amount
  - b. Conversion features into common stock
  - c. Anti-dilution provisions to protect against future down rounds
  - d. All previously issued preferred shares shall be described in the prospectus, and no shares with a more senior liquidation preference should be issued subsequent to this fundraising
  - e. Dividend rights – no dividends shall be declared on other classes of stock without a proportional dividend being declared on the crowd-funding shares

These provisions will protect both the downside and upside interests of investors. It offers protections in liquidation scenarios as well as protection against dilution from future investment rounds. It also provides the ability to reap the benefits in an upside scenario as they possess the ability to convert the shares into common stock.

I believe that these steps can be instrumental in setting up a successful and sustainable crowd-funding mechanism that protects investors without hampering the issuing companies. I would love to speak with you in person upon your review of the suggestions.

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Regards,  
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